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Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW
Washington, D.C. 20554

RE: Docket No. 93-215; Reply Comments amd Proposals of the Small Cable Business Association for Interim Rules for Smaller Operators

Dear Mr. Caton:

Enclosed for filing are the original and 14 copies of the above-captioned document. We have also enclosed a copy with a pre-addressed Federal Express envelope and request that a file-stamped copy be returned to us.

The prompt dissemination of this information to the Commissioners and appropriate staff members is greatly appreciated.

If you have any questions or comments, please call us.

Very truly yours,

HOWARD & HOWARD

Eric E. Breisach

Eric E. Breisach

Enclosures
cc: Mr. David D. Kinley
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
	)	
Implementation of Sections of The Cable Television Consumer Protection and Competition Act of 1992	))))	MM Docket No. 93-215
	)	
Rate Regulation	)	

REPLY COMMENTS
AND
PROPOSALS FOR INTERIM RULES FOR SMALLER OPERATORS

Prepared by:

SMALL CABLE BUSINESS ASSOCIATION

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Dated: July 27, 1994

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SUMMARY

By the Commission's own admission, cost-of-service rate justifications, because of their complexity, were not designed to be the primary rate determination vehicle for cable operators. Rather, benchmarks under the May 1993 Report and Order were intended to be the front line methodology, to be replaced in the future by across-the-board full reduction rates in the *Second Order On Reconsideration* ("*Second Reconsideration Order*").

The widespread failure of the Commission's benchmark methodologies, including most "transitional" methodologies to provide meaningful relief for smaller systems and operators, forces those operators into wholesale use of cost-of-service computations. This begs two questions: (1) is this justifiable; and (2) does this place a special responsibility on the Commission to ensure that the cost-of-service rules provide a safety net for these operators?

The first answer is no. It is simply not justifiable that the Commission's actions in its other rate regulation docket[1] in effect mandate that smaller operators use this more complex and expensive rate regulatory methodology. To fulfill its statutory obligations to allow an operator to earn a fair profit, the Commission must tailor the cost-of-service rules, at least on an interim basis, to accommodate the legitimate rate adjustments required by smaller operators and operators of smaller systems.

The current regulatory scheme lacks parity. In its benchmark/full reduction rulemaking, the Commission determined that certain operators and systems should be entitled to interim protection from the full impact of rate regulation because those operators

[1]MM Docket 92-266.

and systems might not have earned monopolistic profits, are too small to attract capital to overcome the impact of rate regulation, or both. No similar provisions have been established in the cost-of-service proceeding. All of the harsh cost-of-service treatments imposed because of the presumption of monopolistic profits remain intact across the board. Therefore, if the interim "transitional" rules do not accord adequate protection to cable operators under the benchmark/full reduction rate, cost-of-service justifications will likely not provide any safety net because of its imbedded assumptions and requirements to exclude items from the ratebase. These items must change, at least on an interim basis.

Specifically, the Commission must make the following revisions in the cost-of-service rules, at least as they apply to smaller systems/operators[2]:

1. Increased Presumptive Rate of Return. The presumptive rate of return must be significantly increased for these operators. The cost of equity investment in small closely held cable businesses has historically averaged 30 percent and that rate of return remains valid under recognized cost of equity valuation theories. This is a far cry from the 14 percent assumed by the Commission. It is not enough that operators may overcome a regulatory presumption; the Commission must create a higher presumption to ease the administrative burden and alleviate the risk associated with filing a cost-of-service showing.

[2]The term "smaller systems and operators" is not a reference to the Commission's current size standards that were promulgated in violation of the Small Business Act and the Regulatory Flexibility Act. Rather, the classifications used to determine who receives interim relief should be substantially broader.

2. Prior Losses Must Be Recoverable. In its *Notice of Proposed Rulemaking* ("NPRM"), the Commission placed great emphasis on the investment cycle of a business, correctly noting that losses are incurred during the early years of a business, only to be recovered by higher than normal profits in the later years. In the instant case, the Commission is imposing a rate setting methodology that mandates declining profits in future years, never allowing for recovery of the prior losses. The FAS 51 standard of measurement for recovery of prior year losses is wholly inadequate both in overall concept and application to smaller operators and systems. First, the FAS 51 standard is an accounting measure to facilitate matching of income and expenses for periodic financial reporting purposes. It bears no relationship to long-term economic profits. Second, only large systems typically even have a prematurity period under FAS 51. Most smaller systems either never have one or have a very short period (i.e., several months). Nevertheless, these systems might incur losses for years.

3. All Acquisition Costs Must Be Recoverable. The Commission maintains that many acquisition intangibles are presumptively excluded from the ratebase as they were allegedly procured for the right to earn monopolistic profits. First, especially with respect to smaller systems which typically serve more rural areas, the ability to earn monopolistic profits is questionable at best. Even if such amounts are to be excluded from the ratebase, the Commission is essentially legislating the bankruptcy of smaller operators with acquired systems. The Commission ignores that real money was paid at arm's length for the intangibles. Most often, the real money paid was borrowed real money. Borrowed real money must be repaid to the lender in real money. The

Commission's presumptive exclusion of such intangibles destroys the ability of those operators to charge rates that will allow repayment of debt. Absent a compensatory mechanism to relieve this structurally created hardship, the Commission must allow all acquisition intangibles and tangible asset acquisition costs to be recoverable through the ratebase. Without such relief, smaller operators without ability to cross-subsidize the costs of the acquired systems will simply be forced into bankruptcy.

These revisions must be made to the cost-of-service rules, even if only on an interim basis until the benchmark/full reduction methodology is finalized or more meaningful transition relief is implemented. Clearly, the Commission should use the results of the soon-to-be-performed cost studies to tailor the cost-of-service presumptions to systems of varying size and other relevant attributes.

In the interim, the Commission has the choice of, at a minimum, implementing the above listed adjustments for some or all cable operators. Given the pending legal challenges to the current small operator standard, the Commission would be ill advised to attach even greater significance by expanding the application of its current company size standards. If the Commission chooses to implement the foregoing changes for less than all cable operators, it must include a sufficiently large group of operators to provide relief to those privately held companies needing relief.

The Small Cable Business Association recognizes the difficult position the Commission finds itself in regarding adoption of interim provisions to protect the interests of smaller cable operators and systems. Nevertheless, the Commission has already determined on the record that certain operators and systems require protection from the full impact of rate regulation pending completion of the cost studies. The same protection must be accorded these operators and systems under cost-of-service, regardless of the difficulties, even if it means providing interim rules for the entire industry. To simply refuse the protection for the smaller operators and systems would constitute an arbitrary and capricious action.

I. INTRODUCTION

The Small Cable Business Association ("SCBA") is a self-help group formed by small cable operators faced with an unprecedented labyrinth of overwhelming regulations. SCBA's primary purpose is to help small operators learn, understand and implement the new requirements.

SCBA is barely one year old. Several small operators decided to meet in Kansas City on Saturday May 15, 1993. Word of the meeting spread and one hundred operators attended. The Small Cable Business Association was formed by the end of the day.

From these simple beginnings, SCBA has rapidly grown to over 325 members. More than half of them have fewer than 1,000 subscribers in total. SCBA continues its mission to educate and assist small operators using unpaid, volunteer leadership. SCBA has also been very active in the rulemaking process in this Docket.

II. IMMEDIATE CHANGES TO THE INTERIM RULES ARE NECESSARY TO PROVIDE AN ADEQUATE SAFETY NET FOR SMALL OPERATORS AND OPERATORS OF SMALL SYSTEMS.

A. The Cost-Of-Service Rules Must Provide A Safety Net.

The Commission refers to the cost-of-service rate methodology as the safety net to ensure that operators are not prohibited from charging rates that enable them to earn a reasonable profit[3] as required by statute[4]. As demonstrated below, the current transitional treatments accorded smaller operators and smaller systems fail to provide meaningful relief.

1. Interim Transitional Relief Does Not Provide Broad Protection For Smaller Operators.

The regulations promulgated by the Commission in the *Second Reconsideration Order* required most operators to roll rates back to full reduction levels (i.e., 17 percent below the rates charged on September 30, 1992). This amended a maximum 10 percent reduction from the September 30, 1992 rates as part of the Commission's *Report and Order* released May 3, 1993. Three classes of systems were identified for "transition" treatment in the *Second Reconsideration Order*, meaning that the full reduction need not be taken immediately, pending the completion of an industry cost study.[5]

The transition relief classifications were for "low cost systems," those whose benchmarks are above full reduction rates;[6] "small operators," those systems owned by

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[3]*Second Reconsideration Order* at footnote 213.

[4]*See*, e.g., 47 U.S.C. §543(b)(2)(C)(vii) which requires rate standards to be established to include "a reasonable profit...."

[5]*See*, e.g., *Second Reconsideration Order* generally at ¶¶117 - 131.

[6]47 C.F.R. §76.922(b)(4)(B).

companies having fewer than 15,000 total subscribers;[7] and "small systems" owned by small multiple system operators.[8] Although small systems and operators are not precluded from seeking "low cost system" treatment for a particular system, only the latter two methodologies were crafted specifically for smaller systems and operators. Each methodology is described below.

a. Low Cost Transition Relief

If an operator's benchmark rate, as derived by the Commission's formula, is above the full reduction rate, the operator need only reduce its current rate to the benchmark level, deferring the remainder of the reduction until completion of the cost study. This methodology seldom provides protection for smaller systems and operators because the design of the benchmark system results in lower rates for smaller systems and operators than for larger ones. In addition, a number of factors which significantly increase the amount of the benchmark rate are typically not found in smaller systems and operators.[9]

(1) Small Operator Transition

The Commission defined small operators as those with 15,000 or fewer subscribers.[10]

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[7]47 C.F.R. §76.922(b)(4)(A).

[8]47 C.F.R. §76.922(b)(5).

[9]For example, independently owned systems have much lower rates than MSO owned systems, smaller operators typically operate in more rural areas with lower median household income amounts, smaller operators have fewer systems, and smaller systems and operators frequently did not charge separately for remote controls or tier changes (assuming an operator had more than just a basic tier), all of which reduce the amount of the benchmark rate.

[10]47 C.F.R. §76.922(b)(A).

The Commission established this definition with no support[11] for its rationale for selecting the 15,000 subscriber number.[12] These small operators are entitled to avoid any additional rollbacks from their March 31, 1994 rates.[13]

(2) Small System Transition

Congress mandated that the Commission reduce the administrative burdens on small cable systems.[14] The Commission also determined that such systems should not be required to roll rates back by the full reduction rate at the current time.[15] To qualify, however, according to the Commission, the system must be owned by an MSO that has an average system size of 1,000 subscribers or less and has no single system with more than 10,000 subscribers. SCBA has determined that for operators with more than 15,000 subscribers (who qualify for small operator transition treatment), only 16 of 106 possible

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[11]The Commission merely relies on its "beliefs" without citing any factual basis on the record to support the "beliefs." *See, Second Reconsideration Order* at ¶120.

[12]*Second Reconsideration Order* at ¶120.

[13]This does not allow operators to avoid the rate regulations promulgated and complied with by the operator prior to the *Second Reconsideration Order* which could result in a rollback of at least 7 percent (i.e., a 10 percent rollback less a 3 percent inflation adjustment).

[14]47 U.S.C. §543(i).

[15]*Second Reconsideration Order* at ¶209. The full reduction rate is 17 percent less an inflation adjustment of 3 percent (a net of 14 percent). Qualified small systems need only reduce rates from current levels. Full reduction rates often require the loss of rate increases implemented in the normal course of business during the period October 1, 1992 through April 5, 1993 (the beginning of the rate freeze). Therefore, full reduction rates frequently require more than a 14 percent net rollback.

MSOs meet the strict qualifiers imposed by the Commission.[16] Therefore, even though the Commission established a class entitled to relief, it defined the group so narrowly as to exclude 85 percent of such MSOs.[17]

2. Failure Of Transition Relief Forces Smaller Operators And Systems Into Wholesale Cost-Of-Service Showings.

In comments filed September 14, 1994, SCBA put the Commission on notice that if appropriate modifications were not made in the benchmark methodology, smaller operators and operators of smaller systems would be forced wholesale into cost-of-service showings.[18] As a result of the failure of transitional relief, this prophecy has unfortunately been fulfilled and statutory requirements violated.

B. Remedial Action Must Be Implemented Immediately, Even If Only On An Interim Basis.

Time is of the essence. Smaller operators and systems need a workable rate regulatory scheme now. Although a rework of the benchmark/full reduction rate system is possible, it does not appear to be imminent. Furthermore, the cost studies to be undertaken pursuant to the *Fifth Notice of Proposed Rulemaking* in MM Docket 92-266 will not be completed for at least another year, if not longer. The most pragmatic method to provide interim relief short of lifting all regulation is to modify the interim cost-of-service rules to

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[16]SCBA has gathered this information from a review of the Nielsen database of cable operators and systems.

[17]It is important to note that Congress' statutorily-imposed mandate to provide relief to small systems demonstrated no intent to qualify relief given to a small system based on ownership of the system. Therefore, there is no legal basis whatever in the Cable Act for the Commission's limitation based on system ownership.

[18]*Reply Comments Of The Small Cable Business Association*, MM Docket 93-215, filed September 14, 1993, at p. i.

address the concerns of small operators and the operators of small systems. These changes must be made now.

III. THE PRESUMPTIVELY ALLOWABLE RATE OF RETURN MUST BE INCREASED FOR SMALL OPERATORS AND OPERATORS OF SMALL SYSTEMS.

A. The Presumption Must Be Changed.

1. The Strong Nature of Commission Presumptions.

All of the interim cost rules are not mandates, rather presumptions[19] which are theoretically rebuttable. In general, however, most operators view a Commission presumption as being a very high threshold to overcome. Additionally, franchise authorities will have first crack at the rate justifications and are highly unlikely to deviate from or feel that they have the expertise to deviate from a Commission presumption. These factors, when combined, illustrate the reluctance that operators have to attempt to overcome a Commission presumption.

2. As A Matter Of Public Policy, Regulatory Presumptions Must Be Based In Reality.

As a matter of public policy, the societal cost of unrealistic presumptions should be avoided. If evidence on the record supports a finding that a regulatory presumption misses the mark and will result in thousands of cable operators/systems making individual showings to overcome the presumptions, is it not in the best interest of the public to devote public and private resources to resolutions on an individual case basis. Rather, it would be much more efficient if the presumptions would simply be modified to reflect reality.

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[19] *Report and Order* at ¶19.

3. The Burden Should Not Always Fall On The Smaller Operator.

Rate regulation burdens seem to fall hardest on small operators. The rate of return issue is no exception. The equity rate of return assumptions chosen by the Commission are based on characteristics of large publicly traded telephone companies. While fundamental differences between the telephone and cable businesses may make the use of a surrogate rate of return entirely inappropriate for all cable operators with the disparity being the greatest between the presumed surrogate rate of return and that required by small privately held cable operators. Once again, the necessity to overcome the burden falls hardest on smaller operators and the operators of smaller systems as they are typically small family owned entities for which the cost of equity investment is very high.

B. The Presumed Rate Of Return Should Be Higher For Smaller Operators.

The Commission views its statutory charge as "allow[ing] the opportunity to earn a return sufficiently high to maintain the company's financial integrity and ability to attract new capital."[20] As discussed below, the currently prescribed 11.25 percent[21] rate simply does not accomplish this objective for smaller companies.

1. Paine Webber Analysis Supports An Equity Rate Of Return "Well Above 20 Percent."

Paine Webber Incorporated performed an analysis of the return on equity required by equity investors in cable television entities. The information provided by Paine Webber supports a historical rate of return for equity which often exceeded 30 percent and currently

[20] *Report and Order* at ¶204.

[21] The cost of equity component used by the Commission is approximately 14 percent.

a requirement for small companies to earn equity rates well above 20 percent if they are to attract capital[22].

a. Small Operators Have Historically Been Required To Provide Equity Rates Of Return Exceeding 30 Percent.

Mr. Dixon, Senior Vice President, Paine Webber, specializes in financial analysis of cable television companies. In Mr. Dixon's experience, the average cost of equity before reregulation was "above 25 percent," with the rate for early stage, smaller companies with higher risk requiring returns "exceeding 30 percent."[23]

b. Current Equity Requirements For Small Cable Operators Are "Well Above 20 Percent."

Paine Webber utilizes a model developed during the post-highly leveraged transaction period which quantifies anticipated equity returns due to the combined effect of cash flow growth and capital structure, and makes use of the methodology developed in the Dupont model.

The model, as illustrated in the example provided by Mr. Dixon of Paine Webber, is very conservative in that it understates the expected equity return because it assumes a constant level of debt while a portion of the equity return is reinvested in the business. The internal rate of return Mr. Dixon computed was 24 percent, assuming a 50 percent debt/equity capital structure. The higher the debt percentage, the higher the risk, the higher the equity return required to attract equity investment.

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[22]Letter from Christopher P. Dixon, Senior Vice President, to Eric Breisach, Howard & Howard, dated July 6, 1994, enclosed as an exhibit.

[23]*Id.* at p. 1.

The Paine Webber analysis clearly demonstrates that both historically and currently, the rate of equity return for smaller privately held cable operators is at a minimum between 25 to 30 percent. SCBA maintains that the presumed rate of return for the equity component of the cost of capital computation be 30 percent.

2. Small Operators Have Historically Incurred Cost Of Equity Approaching 30 Percent.

Attracting outside equity capital to small privately owned cable television companies has always posed significant challenges[24]. SCBA requested information from a number of its members who have either seriously attempted or actually procured outside equity investors. SCBA also asked for input from two of the major cable finance firms based on their experience. This historical data clearly shows a return on equity for smaller cable operators of between 25 and 30 percent[25], with the rates tending towards the upper limit.

Most of the equity return information was based on equity returns required prior to the implementation or rate regulation. With pending rate rollbacks and severe restrictions on the ability to increase rates, the inherent risk in equity investment in small cable operators has increased, pushing the rate of return required by equity investors to over 30 percent. The only SCBA member commenting on the current status believes that equity investors are no longer available at rates under 30 percent.[26]

[24]Many of the privately owned companies are often family owned, making them even more closely held because of a family's tendency to vote their ownership interests in a block, thereby increasing the risk of becoming a minority equity holder.

[25]See attached chart of responses and copies of information from each of the respondents enclosed as exhibits to this filing.

[26]See letter from Stanley Searle of Pioneer Cable which is enclosed as an exhibit.

3. A Widely Recognized Capital Asset Pricing Model Technique Supports A 30 Percent Rate Of Return.

In its *Reply Comments* filed September 14, 1994, SCBA introduced on the record a model to value equity rates of return based on a variation of the Capital Asset Pricing Model ("CAPM"). SCBA hereby resubmits these comments by reference as further support that an appropriate rate of equity return for at least smaller privately owned companies is in the vicinity of 30 percent. Although these comments were part of the record during the last rulemaking, they were entirely ignored by the Commission -- without so much as an explanation in the *Report and Order*.

Under the CAPM, investors require a rate of return equal to the current risk-free rate plus a risk premium which is determined by the unique characteristics of each company.[27] The risk free rate is the current yield on long-term U.S. Treasury Bonds.[28] The current yield on a 20 year U.S. Treasury Bond is 7.58 percent.[29]

A more comprehensive analysis is required to determine the risk-premium to be added to the risk-free rate to compute the overall capitalization rate. Factors which should be included in this analysis include:[30]

1. General economic conditions;
2. Industry-specific factors; and

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[27]Pratt, Shannon P., *Valuing A Business; The Analysis and Appraisal of Closely Held Companies*, (2d ed. 1989), pp. 45 & 46.

[28]*Id.* at p. 198.

[29]*Wall Street Journal*, July 26, 1994, page C24.

[30]Zukin, James H., *Financial Valuation: Business and Business Interests* (1990), ¶5.1[3].

3. Company-specific factors.

The greater the risk factors, the higher the requisite rate of return must be in order to justify investment in a business venture.

While operating in a heavily regulated industry with stringent regulation of rates certainly raises the risk level, small cable businesses and operators of smaller systems have attributes, including reliance on a few key operating personnel (i.e., typically owner operated business), highly leveraged and high variability of earnings[31] which also contribute to the entities' risk.

An accepted method of determining the discount factor used in the Capital Asset Pricing Model, which would also be equivalent to the required cost of equity[32], can be ascertained by adding to the risk-free rate of return a risk premium derived by reference to a table of business characteristics developed by James H. Schilt[33].

In the table of five categories identified by Schilt[34], small cable businesses and

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[31]The SCBA surveyed its members to determine various attributes to help the Commission craft its cost-of-service regulations. Many operators showed highly variable earnings from year to year as well as substantial operating losses.

[32]Brigham, Eugene F., *Financial Management Theory and Practice* 2d, p. 561.

[33]Schilt, James H., *Selection of Capitalization Rates for Valuing a Closely Held Business*, Business Valuation News, 1992, and Schilt, James H., *Selection of Capitalization Rates - Revisited*, Business Valuation Review, June 1991, p. 51. The various risk premiums were determined based on a quantitative analysis of historical equity risk premiums such as those published by Ibbotson Associates. (*See*, e.g., Ibbotson and Sinquefeld, *Bonds, Bills and Inflation: Updates, Financial Analysts Journal*, July - August 1979).

[34]Although the Schilt model is based on the capitalization rate rather than the discount rate typically used to determine cost of equity, the discount rate is equal to the capitalization rate where the growth rate is equal to zero. Under the Commission's rate structure, it is doubtful that operators will be able to increase rates faster than the rate of inflation, or the rate of increases in actual costs. Additionally, productivity gains for small businesses and

operators of small systems seem to fit best below category 2, but no lower than category 4[35].

Category 1 does not apply since most such businesses and systems are not well financed, do not have depth in management, have not had stable past earnings and certainly do not have a future that is highly predictable.

Category 2 does not apply since small businesses and systems typically lack adequate financial resources, do not have depth in management or stable past earnings and do not have a predictable future.

Category 3 is closer in that such businesses and operators typically do not have management depth and the element of risk is high.

Similarly, Category 4 is also relevant to certain operators since many small businesses rely upon the special skills of one or two people. In addition, especially with the onset of regulation, future earnings may be expected to deviate widely from projections.

For discussion purposes, even if we assume that the appropriate risk premium is the midpoint of the lowest applicable category (i.e., category 3), the risk premium is still 18 percent[36]. When added to the current risk-free rate of 7.58 percent, the cost of equity

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systems are highly speculative. Therefore, it is likely that there will be no real rate of growth in cable earnings in the foreseeable future. Hence, the discount rate will be equal to the capitalization rate in the instant analysis. *See*, e.g., Sliwoski, Leonard, *Capitalization Rates, Discount Rates, and P/E Ratios: One More Time*, Business Valuation Review, September 1992, p. 12.

[35]For a complete description of each category, see a reproduction of the table attached as an exhibit to this filing.

[36]Nevertheless, under the Schilt model an appropriate risk premium for small operators is at least 25 percent.

under the Schilt model would be 25.58 percent. This is substantially higher than the proposed rate of return on equity adopted by the Commission of 14 percent.

4. All Evidence Supports A 30 Percent Return On Equity.

Whether the Commission prefers to examine the Paine Webber analysis, historical data, or a Capital Asset Pricing Model analysis, the net result is the same -- the cost of equity for smaller companies is approximately 30 percent. The size of an operator is not the sole determining factor. Another major factor is that smaller operators are typically privately, often family, owned. Close ownership of an operator means that a significant premium must be paid to compensate for the non-marketability of such ownership interests.

Smaller operators typically have higher costs of equity compared to larger operators. Many times the larger the operator, the lower the required rate of return. Absent the collection of empirical data to define a cutoff, however, the Commission must allow this higher rate of return to most, if not all, non-publicly traded cable operators. The Commission is not in a position to limit the higher rate of return to any size of cable operator. Conversely, it cannot deny the higher rate of return to smaller privately held cable operators because doing so would deprive these operators of their ability to use cost-of-service as a viable rate computation methodology. Considering the significant legal challenges that have been launched against the validity of the 15,000 and 250,000 subscriber definitions, the Commission should not attempt to expand the uses to which these improperly created size standards are put.

5. The Revised Presumptive Cost Of Capital For Smaller Operators Is 21.4 Percent.

Using the Commission's assumed 40/60 debt to equity ratio, assuming that the presumptive interest rate of 8.5 percent of debt remains unchanged, and an equity return of 30 percent, the weighted average rate of return for smaller privately held operators is 21.4 percent.

IV. FULL RECOVERY OF PRIOR YEAR LOSSES MUST BE INCLUDED IN THE RATEBASE.

A. The Commission Was Correct When It Examined Profitability In Terms Of The Investment Cycle Concept.

In its *Notice of Proposed Rulemaking,* the Commission embraced the investment cycle of a business as one way to examine profitability levels of cable operators. The Commission emphasized that in the ordinary course of business, operators incur losses during the initial years of operation. Under the investment cycle theory, a business owner typically loses money during the initial years of operation, gradually breaks even, and then earns higher than normal profits in the later years to offset the earlier year losses. This earnings pattern is typical among the cable industry.

As a result of price deregulation under the 1984 Cable Act, many smaller cable operators were formed during the late 1980s to provide service to rural America, areas which operators could not afford to service under price regulation. Consequently, many smaller operators are either nearing their break even point, or are still incurring losses.[37]

Now, however, the Commission, by imposing the FAS 51 standard for recovery of prior year losses, seeks to strip operators, especially smaller operators, of their ability to recover these losses.

[37] A survey of SCBA members in August 1993 revealed that of those responding, more than half had incurred losses during one or both of the preceding years.

B. The Current FAS 51 Standard Is Wholly Inadequate.

1. The FAS 51 Standard.

Financial Accounting Standard 51 ("FAS 51") permits the capitalization of operating losses during the "prematurity period." The "prematurity period" begins with the activation of the plant and ends upon completion of the first major construction period.[38] The period, absent extraordinary circumstances, cannot extend beyond two years.[39]

2. The FAS 51 Standard Is Inappropriate.

The purpose of the FAS 51 standard is to match revenue with expense for purposes of periodic financial accounting reporting. It eliminates the full recognition of losses during the period when a cable system is first being activated and spreads those losses over later periods.

The standard does not and was never intended to prevent a loss in any given year. It is wholly inappropriate for measuring recovery of economic losses over the life of an investment.

3. The FAS 51 Standard Discriminates Against Smaller Operators.

The prematurity period is a function of system size. The larger the system, the longer the period between initial activation and completion of construction. The larger the system, the longer the period. The smaller the system, the shorter the period.[40] In fact, many smaller systems have a negligible prematurity period, if any. Therefore, to the extent that

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[38]Financial Accounting Standards, §Ca4.403.

[39]Financial Accounting Standards, §Ca4.102.

[40]Financial Accounting Standards, §Ca4.403 (a) - (c).